Washington State Community, Trade and Economic Development

September 11, 1996

Mr. Steve McLellan, Secretary
Washington Utilities and Transportation Commission
1300 S. Evergreen Park Drive SW
PO Box 47250
Olympia, WA 98504-7250

Re: Staff Recommendation Regarding Purchased Gas Adjustment (PGA) Incentive Mechanisms and Hedging Policies; NOI Docket No. UG-940778

Dear Mr. McLellan:

Thank you for sharing staff's purchased gas adjustment (PGA) recommendations and for providing us the opportunity to comment. The Washington Energy Policy Group (Group) would like to offer a few comments on the mechanism that staff has proposed.

As staff has noted, the natural gas industry has undergone significant changes over the past several years. In the past, there were relatively few supply options; natural gas was delivered and paid for primarily through long-term contracts. The deregulation of wellhead prices, the introduction of open access to the pipeline industry, the development of a complex supply market with numerous players, and the evolution of futures markets and other hedging tools have fundamentally altered the way gas is purchased. Today, a local distribution company (LDC) faces a dizzying array of choices.

Paradoxically, as the number and variety of gas supply options have mushroomed, the ability of an LDC to control its commodity costs has declined. LDCs and their customers are now more exposed than ever to the fluctuating prices inherent in any commodity market. As a result, regulatory regimes in which retail prices are allowed to change only once a year or once every several years may no longer be appropriate. On the other hand, the introduction of least cost planning has provided a useful tool to LDCs to identify ways to hedge against such fluctuations. These tools include hedging instruments, options, storage, long term contracts, purchase of natural gas fields, and the like. Regulation should encourage LDCs to find innovative opportunities both to minimize risk and price. Both the risks and the costs or benefits should be shared appropriately among ratepayers and shareholders. A properly designed external benchmark could perform this function adequately. Several external benchmarks exist today. If they are to work meaningfully then penalties and rewards have to be applied consistently.

LDCs should take advantage of these opportunities in designing a portfolio management strategy. If providing a new incentive and penalty mechanism will achieve this end, then we support the Commission implementing such a mechanism on an experimental basis. In a fully functioning market, however, it is unreasonable to expect a company to be able to "beat the market" in the long run. A given portfolio management strategy might allow a company to purchase commodity gas below market for a certain period of time. In the long run, however, the average price paid by a company under any strategy will approach the average market price over the same period.

Because LDCs have less opportunity than before to control their commodity costs, future reductions in product cost will be due much more to supply and demand conditions in the gas market than to any particular strategy adopted by an LDC. The question then becomes, who should bear the risk of fluctuating prices, the ratepayers or the shareholders? The Group feels that the answer is: both. If the shareholders bear some risk, LDCs would be free to engage in whatever level of risk management they felt appropriate, and would have a strong incentive to develop diverse supply portfolios. Placing some risk on the ratepayers would encourage price-induced conservation and/or load management in times of tight supply, and would allow ratepayers to benefit when prices fall.

The Group advocates the use of an external benchmark to accomplish both of these goals. Such a benchmark should be disconnected from the actual market in which the companies operate in order to reduce companies' ability to affect the benchmark through their actions, while reflecting actual cost of purchasing gas in the Northwest as accurately as possible. Staff has already noted the difficulty of determining the prudence of hundreds of small-scale transactions each year. By disconnecting rates from the price actually paid by the company, a benchmark would lessen the need for regulatory scrutiny. Companies would have the incentive to reduce costs, since their compensation would no longer be based on those costs. Customers would see marginal price signals and would thus have the incentive to conserve when prices are high. Furthermore, customers would be insulated from poor decisions made by their suppliers.

Such a mechanism could also be seen as an experimental step towards unbundling. The PGA and other gas cost incentive mechanisms already reflect "functional unbundling", as product costs are treated separately from distribution costs. With a properly designed benchmark, customers could enjoy rates that are based on the market without the risk associated with full blown competition.

Finally, the Group does not feel that incentive mechanisms and hedging are separate issues. A well-designed incentive mechanism will encourage the proper use of hedging tools by LDCs. Similarly, the twin issues of incentives and hedging cannot be discussed absent the context of future changes in the industry, specifically, the concept of unbundling.

Again, thank you for this opportunity to comment.

Sincerely,

K.C. Golden
Assistant Director
Energy Service Area